EMERGING COMPANY ESSENTIALS: GETTING PAID

Early stage entrepreneurs with limited resources and even less cash know the frustration of trying to attract customers. Unfortunately, some entrepreneurs experience a worse state: the exasperation of landing a customer who takes the goods or services but refuses to pay. The agony can be downright fatal to an early stage company.

So what can you do? Be vigilant and be resilient in all aspects of your business: (i) think through and implement appropriate contractual terms; (ii) prepare contingency plans; and (iii) understand and pay attention to the signs of distress that may topple a trading partner. These are essential to prevent financial contagion – the grim state when the failure of others spreads to your own business.

APPROPRIATE CONTRACTUAL TERMS

Most commercial deals, even cocktail napkin deals, will usually cover price, quantity and payment terms. However in the thrill of the moment when a customer has agreed to sign up, the parties will often become irrationally exuberant about the quantity and duration of credit to extend.

The best way not to inherit a customer's financial woes is to extend as little credit as possible. Prepayment is rare but amazing because it can create a positive cash flow cycle. Where impractical, think about getting paid within a short time frame, and following up for payment. Where a longer extension of credit is required to seal the deal, try and limit the amount of the credit outstanding at any one time.

A customer who demands significant credit for goods that will consume a high volume of resources to produce presents a dangerous situation

In such circumstances, where non-payment might prove fatal and pre-payment is not possible, it might be appropriate to demand a third party guaranty or some other form of credit support like a bank letter of credit.

In addition to rapid collection efforts, startups should also have the benefit of contractual language that provides a basis to impose fees and interest on late payments. This serves to set expectations and to incentivize prompt payment, it may also provide some additional compensation to the vendor in the event of a customer insolvency proceeding.

THERE SHOULD BE CLEAR REMEDIES UPON A CUSTOMER'S DEFAULT.

If interest charges and late fees are the "stick," early stage ventures can also offer the "carrot" of discounts for early payment. In combination, such methods can decrease the credit risk to the startup from a customer's nonpayment.

Most particularly, there should be clear remedies upon a customer's default. Among other things, late payment or non-payment should allow the vendor to reduce the future credit terms or terminate the deal. Often vendors will not want to contract for, or ultimately to use, such rights, because they don't want to alienate the customer or fear a reputation for being inflexible. However, customers who cannot or will not pay are a significant drag upon a startup's growth. Management should have no fear of exiting these relationships and communicating to the marketplace that the business expects to be paid for its goods and services.

In addition to credit and payment terms, many deals lack sufficient specificity around other key terms such as warranties, indemnification, insurance and limitations of liability. These are additional areas where good contracting reduces risk.

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CONTINGENCY PLANS

Contractual terms alone do not guarantee payment. Vigilance and resilience require a company to think through possible responses to nonpayment well in advance of such a situation actually materializing.

Questions to consider: should an early stage company engage in the cost and time of credit checking its customers? If not, should the business acquire receivables insurance to hedge against the risk of nonpayment either by a pool of payors or a specific customer? On what terms and at what expense would this be efficient?

If nonpayment did occur, could the company redeploy resources quickly to service other accounts in order to minimize the net impact of the loss of the revenue? Could various operating costs be reduced or right-sized on a relatively quick basis?

An early stage company with significant payment risk from a large customer should also understand its particular contractual and legal remedies. For example, in some contexts nonpayment may give rise to the ability to send a demand letter seeking to "reclaim" goods. Such reclamation rights are typically subject to strict time limits, so it is useful to understand the rules of the road, and in some cases have forms of demand letters available for rapid use.

Where a company has significant unpaid amounts, does the company have a good process for identifying which customers would pay over time, versus which customers cannot or will not pay? Knowing the difference between these cases and tailoring response efforts appropriately is essential.

One additional strategy is determining in advance whether unpaid receivables can be sold or collection efforts supported through third party collectors. This can reduce the time and quantity of unpaid receivables and potentially generate critical cash. Proper contingency planning requires understanding the risk that a late payment from the customer might be subject to clawback as a "preferential payment" in the event of a bankruptcy filing of the customer.

Other contemplated contingency plans may include the possibility of seeking mediation, commencing litigation or (in the event of widespread financial issues) joining an involuntary bankruptcy against a customer or participating in an out of court restructuring.

In all circumstances, rapidity of the response and a clear plan are the critical factors. Vendors should not be caught off guard if a customer falters. Be prepared with a contingency plan that includes strategies to obtain payment through persistent and creative means.

AWARENESS OF SIGNS OF DISTRESS

Companies encounter distress for any number of reasons. Competitive pressures, regulatory issues, mismanagement, insufficient capital, and fraud are among the more common reasons. Do not expect a partner to provide personalized notice that trouble is brewing and inviting you in for conversation about how to minimize its impact.

Companies that encounter difficulties are typically too busy denying the existence of any difficulty. Those opting not to deny instead frequently invoke the path of delusion: specifically, the delusion that next quarter results will improve based upon nothing more than a desire that results improve. A faltering company often compounds its own problems by failing to take prompt action to identify and remedy the issues.

As such, startups should take any material deviation from the past conduct or communications of customers very seriously. Be on the lookout for such items as amended loan agreements, a change of auditors, unusual litigation, a reduction in force, a change in locations or hours, or an increased concern of solvency "on the street" or on social media. If such information is unearthed, or payment or ordering behavior changes, the vendor must take the time to evaluate its ongoing sales efforts to the customer against the state of its credit exposure.

Where it is cost effective, monitor customer credit. Where you have access to information, stay alert for signs of customer trouble. Where you have customer relationships, ask probing questions and listen carefully to the answers provided. The famous maxim "trust but verify" applies. And if necessary, ask for confirmation of creditworthiness in writing.

There is never a good time to deal with bad news – resist the temptation to put off dealing with a customer's signs of distress. Denial and delusion are hallmarks of faltering companies – not vigilant and resilient emerging companies.

CONCLUSION

Appropriate contractual terms, well-developed contingency plans, and awareness of the signs of customer distress are key aspects of ensuring that high paced startup growth is not interrupted by the financial distress of a customer.

Be vigilant. Be resilient. Be paid.